

**STATEMENT OF
DEPARTMENT OF DEFENSE COMPTROLLER
JOHN J. HAMRE**

**BEFORE THE
SENATE COMMITTEE ON
GOVERNMENTAL AFFAIRS**

FINANCIAL MANAGEMENT REFORM

APRIL 12, 1994

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Thank you for the opportunity to appear before you today concerning the financial management reforms we have undertaken in the Department of Defense. I consider this testimony a unique opportunity to present to you our plans for reforming our financial management systems. Not all of my predecessors would have considered testimony before this committee to be an opportunity, despite what might have been said. But I sincerely do welcome this opportunity to appear before you and share with you what I have learned in the six months since I have been sworn in as Comptroller for the Department of Defense.

I intend in this testimony to present to you a frank and candid assessment of the state of our financial management systems. Secretary Perry answered for the Department, and certainly for me, when he answered a question you posed, Senator Glenn, to him during his nomination hearing. You recounted the recent history of shortcomings in financial management systems in the Department and asked for his comment. He responded "I fear it is worse than you have stated."

May I offer one last comment by way of introduction. I have only one reservation today in offering so candid and blunt an assessment. I fear that without proper context my comments might undermine the spirit of the 46,000 dedicated public servants who work in the financial management area. Despite all of our problems, I am convinced the Department is doing a good job of managing the resources provided by the Congress. But we are able to do this because of an army of dedicated public servants who are working to overcome the limitations of the tools we have given them.

Long-standing financial management problems

We have inherited a troubled system. Its failings are well known.

- Last year we paid defense contractors \$1.3 billion more than we should have and had to recover that overpayment.
- After the conclusion of Operation Desert Storm, we continued to pay 1,100 personnel after they left the Army. Sadly, we even had instances where we paid deserters.
- Last September DoD could not match some \$19 billion in disbursements to specific requirements in acquisition contracts.

I do not want to lay these charges at the feet of my predecessor, for he too inherited this flawed system. Indeed, our deep-seated weaknesses stretch back to the founding of the Republic.

In 1775, the Continental Congress appointed James Warren to be the first Paymaster General. He was in effect the first Comptroller for the Department of Defense, my predecessor. After 6 months in the job, he wrote to the Continental Congress saying he could not do his job properly because of the flaws in the financial management systems he inherited. He complained that each of the 13 colonies insisted on its own payroll system and they were not standardized. The overall system was open to abuse. Frequently individuals would sign up for the militia for one colony to receive the sign-up bonus, only to desert and join another militia to receive its bonus. Pay was not standardized. Uniforms were not uniform. It was chaos.

When Dr. Perry asked me to undertake a thorough assessment of our financial management systems, I reported back to him that we have actually made tremendous progress in the past 200 years. We have added 37 states to the Union and only 5 additional payroll systems.

Legacy of vertically-oriented, chain-of-command organization

Seriously, our financial management problems in the Department of Defense do trace back to the founding of the Republic. I am not trying to lessen my responsibility for changing things by implicating my predecessors in the problems we face. But no enduring reform is possible without properly understanding the true causes of our problems.

The financial management failures of our system spring ultimately from our formal organization. When DoD was established in 1947, it retained the existing organizations with their vertical chain-of-command mode of operations. This vertical chain-of-command organization is essential for success on the battlefield, but it had distinct consequences for peacetime operations. Management systems, including financial ones, were geared to report information up through these vertical channels. When computers came along and every organization sought to automate its processes, these organizations were not compelled to emphasize horizontal connections across organizations of like functions, such as pay or contracting. Instead, computers were used to automate formerly manual procedures. Financial management systems were designed within the chain of command to support the commander of that operation.

At the same time the business of defense in the past 50 years has demanded an unprecedented degree of integration of functions. As the Department of Defense matured, certain activities--such as contract management--were made common across

the Department. But this process of standardization really produced yet additional collections of vertically-oriented chain-of-command organizations.

(Chart 1) My first chart summarizes the consequences of these developments. The legacy of this organizational history is a Department filled with redundant and non-uniform financial management systems. In 1991 when the Defense Finance and Accounting Service was established, there were 66 major finance systems and 161 major accounting systems. Thus, the Department had to create enormously complex business practices to integrate horizontally the necessary functions of the different vertical organizations which had to work together to accomplish the tasks of arming and equipping the military forces in the post-war period.

We learned this painfully simple truth when we set about trying to determine why the Department had so much difficulty matching obligations and disbursements. A good illustration of our findings is the process required to procure a weapon system.

First, let me briefly discuss the theoretical functioning of our system. I will use the F-18 fighter as an example to illustrate the problem. (Chart 2) The chart contains six boxes. In the instance of the F-18, the program manager is in the Navy Air Systems Command. He develops a problem, secures the support of the Navy, defends his budget request inside the Pentagon and ultimately before the Congress. Once the funding is secured, he issues a request for proposal and initiates the procurement process. At that point he hands the problem over to the contracting office, which in this case is also within the Navy Air Systems Command. This office actually awards the contract and negotiates its content. At that point the contractor proceeds to work on the procurement. The contractor sends contract information, invoices, and delivery notices to the Defense Contract Management Command. This is a DoD-wide activity in the acquisition community. DCMC administers the contract, issues modifications to it, accepts and approves deliveries of goods specified under the contract and notifies the Defense Finance and Accounting Office that it has received the goods, permitting DFAS to make payment on the invoice. After the payment has been made, DFAS sends that information to one of its accounting offices which provides detailed accounting detail back to the program manager.

That is the sequence of responsibilities. But now look at the flow of paperwork. (Chart 3) This chart illustrates the primary paper transactions required by this process. Indeed, this is a simplified representation of the actual process. It takes 105 actual transactions to complete the full process.

Why is this so? The problem stems from the fact that the process involves separate vertical chain-of-command organizations. The program manager and contracting offices in

this example were Navy acquisition command offices. DCMC is a DoD-wide acquisition activity. DFAS is a DoD-wide finance activity. (Prior to DFAS there were service-specific finance and accounting activities.)

Unfortunately, buying F-18s is a functional activity that requires a great deal of horizontally integrated activity. So to make the vertical staff organizations accomplish this task, we have engineered enormously complex business practices.

This complexity is the primary reason why we had \$19 billion in unmatched disbursements. An honest, innocent mistake in any one of these paper transactions can produce inconsistencies that require extensive manual research, which results in a build up of unmatched disbursements.

While the paper flows are different, this also is precisely the underlying cause of problems that had us pay 1,100 soldiers for months after they were discharged following Operation Desert Storm. Our personnel systems are not integrated with our payroll systems. We did not have a problem with pay and personnel in the Air Force or the Marine Corps, largely because we have reliable integration of pay and personnel systems for those two services. But we lacked that integration for the Army, and we paid a price for it.

Complacency about Financial Management Problems

I have found that the financial management community was well aware of its limitations, and adapted to these shortcomings. In part, this was because the solutions were perceived to demand actions far larger than any one organization would manage. I have frequently said that our financial records are the thermometer that registers the fever caused elsewhere in the body. The shortcomings show up in our financial records, but they are caused by far more deep-seated problems. Knowing that, it was all too easy for my community to become complacent in the face of our shortcomings.

I recently experienced this problem personally. In February, the Senior Financial Management Oversight Council met to consider the Department's compliance with the so-called Antideficiency Act. Dr. Perry created the SFMOC precisely to deal with long-standing problems in the Department. In preparation for that review, I learned that the Department routinely disburses funds in excess of available balances in individual accounts. In colloquial terms, the Department routinely writes checks on accounts that are "in the red" under the assumption that these accounts are in the red because of innocent accounting errors. I personally believe that these are largely innocent accounting errors, but we also adopted this approach because of the enormously complex disbursing process we have created over the years. To facilitate contract payment, we have charged disbursing offices to pay any "authorized" invoice.

We presume that whoever authorized payment first checked to make sure there were funds in the account. The consequence is that multiple individuals have access to the checkbook and no one is responsible for checking the balance first before the check is written.

I found this totally unacceptable as a practice. Again, I accept the premise that negative balances reflected innocent mistakes. But we have created a system where no one feels it is their personal responsibility to correct the mistakes before we go any further. I encountered great reluctance to change our way of doing business, not because they felt this was the right way to do business, but because this practice was designed to accommodate the complexities of our overall system and the complaining will be bitter when it changes. We are changing, and I fully expect a firestorm of protest as the system adjusts. But we can no longer acquiesce to our systems shortcomings.

Blueprint to Reform DoD Financial Management

As I pledged during my confirmation process, I consider as my greatest responsibility the reforming of DoD financial management. I doubt that I will be in office long enough to witness the full impact of our reforms. But I must take these steps, building on the reforms I inherited from my immediate predecessors, if we are to correct these long-standing problems.

The Department has adopted a six-element blueprint to solve its financial management problems.

Strict Compliance with current requirements. The current system may be inefficient and redundant, but it is the system and we have to make it work better until we can change it. I am pleased to report to you that we are making progress in this regard. Last October the Senior Financial Management Oversight Council met on the problem of unmatched disbursements. As I said, at that time we had \$19 billion unmatched disbursements.

Dr. Perry gave us what seemed like an impossible goal--to reduce that number by 50% by July 1. All of the old professionals in the financial management world said it could not be done. And we are not there yet, but as of February 1, we had that reduced to \$12 billion, a reduction of 37%. This progress is purely the result of hard work by dedicated individuals making the current system work. We have to do more of that until we can solve the underlying problems.

Re-engineer business practices. One of the buzz-words of management today is re-engineering business practices. But clearly that is the solution to our deep-seated problems. Long-term solutions will depend on re-engineering DoD business practices to break down the barriers that persist from the legacy of the past.

There is both a near-term and a far-term dimension to this re-engineering task. Returning to the example of the F-18 contract payment, in the near-term we need to find ways to get arrows off this paper flow chart. And there are ways we can do that. For example, currently both the Defense Contract Management Command and the Defense Finance and Accounting Service enter basic contract data into separate computer systems. Simple key stroke errors create the raw material for unmatched contract disbursements later on. We are exploring ways to have DCMC enter the contract data once and provide that input electronically to DFAS. There are numerous other near-term re-engineering changes we have under review.

In the far-term, re-engineering will be more profound. (Chart 4) This chart provides an overly simple visual aid to understanding our long-term goals. In the long-term, we need to develop standard ways to define information and to share that information so that we can eliminate needless data entry in subsequent offices and rely on the input of the office closest to the task. Once the program manager secures congressional appropriations and enters that data, there is no reason why every subsequent organization and process cannot electronically borrow that information for its requirements. This chart is meant to illustrate this long-term goal.

Standardize definitions, concepts and practices. The key to this long-term vision is found in the Department's efforts under the Corporate Information Management initiative. I am a strong supporter and advocate for CIM. Our progress to date has been modest, but steady. Certainly we promised more through CIM than could be initially delivered. But we are on the threshold of major changes.

In the financial management area, we have over 100,000 data elements in our 250 plus finance and accounting systems. Detailed data modeling has shown that we will require less than 900 to accomplish the full range of our responsibilities. To date progress on data standardization has been slow. But through concerted efforts, I hope and expect that we will have over 400 of the 900 data elements we require in financial management approved by July 1. It is my goal to have 90% approved by the end of the year, and I am modestly optimistic that we will achieve that goal. Once that is achieved, we have agreed on our long-term path. We will have created a common language for our disparate systems to use, or to design a new integrated finance and accounting system.

Design modern finance and accounting systems. I received a great gift from my predecessors when they established the Defense Finance and Accounting Service. I have a tool to use to engineer the needed changes for the future. DFAS has set about the task of streamlining our finance and accounting systems. Where we inherited 18 separate military payroll systems, today we operate only 11, and in two years we will be down to 2. The

same can be said for civilian payroll systems. We inherited 18 and in two years we will be down to only 2.

The benefits from this streamlining are enormous. Today the average payroll clerk services 350 customers. Under our future system, a single payroll clerk will service over 1,500 customers. That is the key to streamlining and downsizing our work force.

We need to do the same in the area of our accounting systems. Here the task is much larger, since all of the existing 161 accounting systems were designed for existing operations, which must continue to operate day in and day out. Our conversion plans here are less well advanced, and present our primary challenge in coming months.

Align financial controls and management incentives. In the past, no one--from senior commanders to supply sergeants--knew or could determine the true cost of the requirements they faced; for example, whether to repair or replace a damaged piece of equipment. Our systems failed to reflect the full cost of doing business. Consequently, individual commanders proceeded with decisions that minimized the cost to their specific organization, even though it quite likely drove up costs overall to the Department. The previous Administration took much needed and heroic actions to correct this problem when they created the Defense Business Operations Fund. DBOF has been a painful reform, however. The initial promises were overstated. Our underlying accounting systems were not up to the task. The reform itself was poorly presented to those most affected by it.

Despite these painful shortcomings, DBOF is working. It has introduced a cost discipline that was absent in our previous system. For the first time, the entire Department is talking about the "cost of doing business".

DBOF has a central problem, however. We have not been able to eliminate unnecessary costs as fast as budgets have been reduced. As a consequence, the ultimate customers continue to bear an increasing burden by higher prices. These higher prices cause them to reduce their demand for those goods and services. The demand falls faster than the depot managers can eliminate costs, resulting in operating losses for the year which must be subsequently recovered through higher prices the next year. This vicious circle is the single largest threat to DBOF. We must take sweeping actions to eliminate these costs if DBOF is to produce its ultimate promise.

The entire DBOF story demands a fuller discussion, and I hope the Committee will invite me to testify again another day on it and all we are doing to make it work.

Practice candor and engender confidence. The final element of our blueprint deals with candor and confidence. We cannot accomplish all these critical tasks without the support of the Congress. We have not always earned that support. And we have made it hard for supporters like you to help us when we have failed to address our problems with the candor they demand. I am convinced the Congress will help us solve our problems if we are honest enough to present them to you and seek your advice and counsel.

This Committee has a distinguished history in pointing out the Department's shortcomings in the area of financial management. Your sincere efforts were frequently rewarded by cold silence. I hope you believe that we are now set upon a different course. We are anxious to solve our problems and we seek your support in our task.

I do not pretend we have found the only way to solve our problems. I welcome any advice and direction you can give us. I would only ask that you not burden us with tasks which do not solve our underlying problems.

Conclusion

Mr. Chairman, I do sincerely appreciate the opportunity to testify before you today. I do so on behalf of the 46,000 civil servants who work in the financial management area. We owe them more than we have given them to do their work. They are carrying the burden every day for the flawed systems we have given them. This committee has been correct to point out our failings over the years. I now ask that you become our sponsors for change.

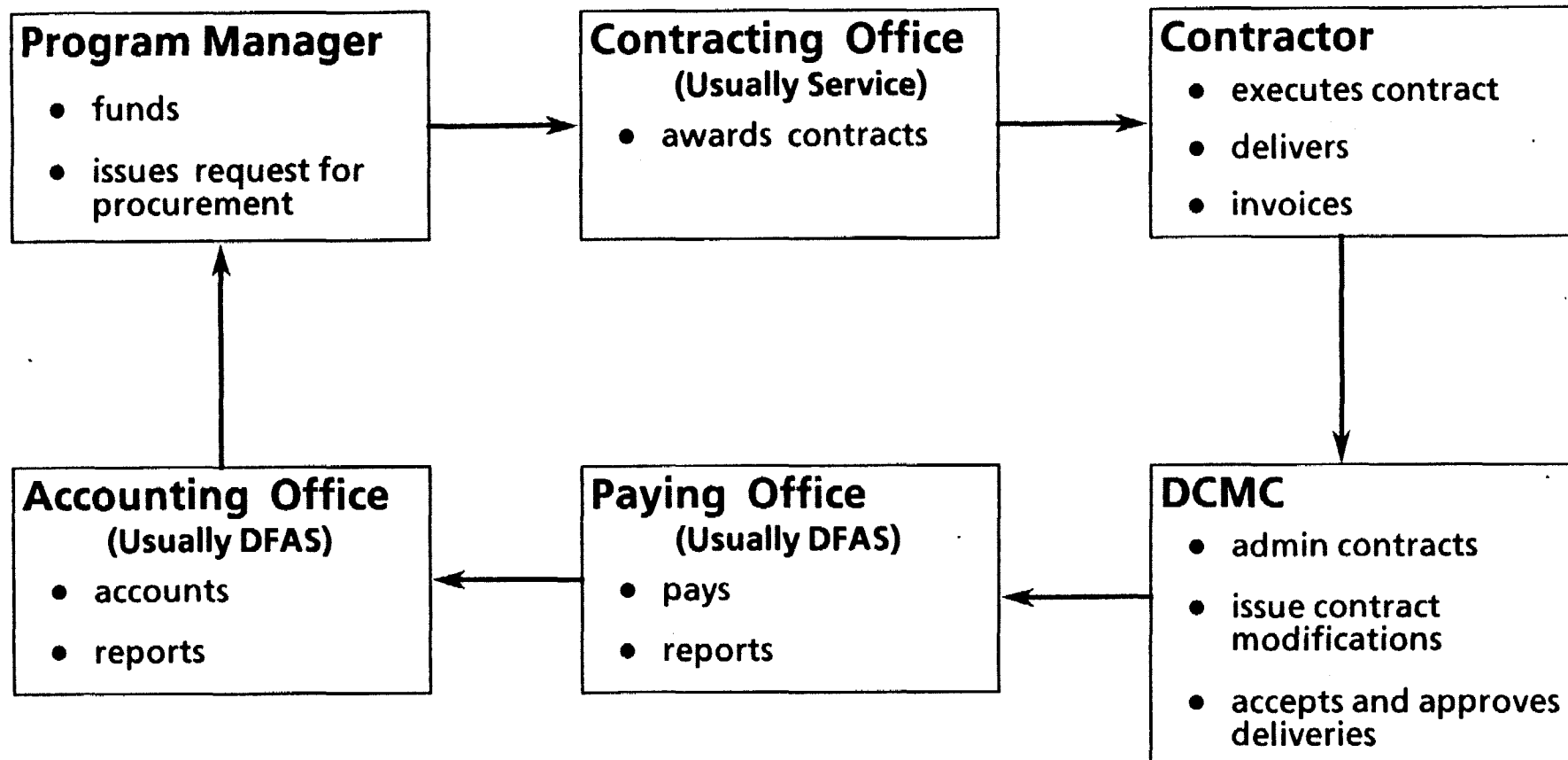
Thank you, Mr. Chairman. I look forward to answering your questions.

IMPACT OF VERTICALLY - ORIENTED STAFF ORGANIZATIONS

- **Complicated Business Practices**
- **Frequent Performance Failures**
(for example, unmatched disbursements)
- **Most Systems useful only Inside a Single Staff Organization**
- **Redundancy/System Isolation**
 - **Limited Automated Interface between Systems**
- **Lack of Common Understanding on Terms, Concepts and Procedures**

Contract Payments Process

(Responsibility Sequence)



Contract Payments Process

(Future Vision)

